B. Harm to Competition in Downstream Markets by Exercising Market Power in Upstream Markets

The NPRM also notes that a second potential exercise of market power, arising from the BOC's market power in upstream markets, may be relevant in this rulemaking. The NPRM correctly notes that this type of market power might be exercised by raising the cost of downstream rivals or restricting those rivals' output through control over access to bottleneck facilities. NPRM ¶ 131. As we explain below, the discussion of this market power in the NPRM is, in significant respects, incomplete. Nonetheless, the Department does not believe that the regulation traditionally applied to dominant carriers would be appropriate in dealing with this type of market power in this context, where the Commission can more effectively address the problems by regulating the BOC directly and by regulating its relationship with its interLATA affiliate.

1. Market Definition

Since we do not believe that the Commission's dominant carrier regulation should apply to the operations of the BOCs' interLATA affiliates, we do not believe it is necessary for the Commission to resolve questions of market definition that would be relevant in assessing the risks that this type of market power would be exercised. Even if there is a substantial risk of the exercise of this type of market power, dominant carrier regulation is not the most effective way of dealing with that risk.

If the Commission concludes that it must define relevant markets in this context, however, the approach outlined in the NPRM requires further refinement. For purposes of assessing the competitive risks associated with the BOCs' control of upstream, bottleneck facilities (i.e., local exchange and access facilities), the Commission's market definition should focus on this upstream market. If and when the BOCs lose their market power in this upstream market, they will also lose their ability and incentive to engage in anticompetitive discrimination and cost misallocation.

In drawing the distinction between interLATA services that originate in-region and those that originate out-of-region -- a distinction that reflects differences in the upstream market power of the BOC -- the NPRM seems implicitly to recognize that an analysis of the upstream market is needed. In considering the market definition of interLATA services, the Commission noted that "economic factors and the realities of the marketplace should cause point-to-point markets to behave in a sufficiently similar manner to allow [the Commission] to evaluate broader, more manageable groups of markets." NPRM ¶ 124. Similarly, in the context of local exchange and access services, the Commission seems to have concluded that in-region point-to-point markets could be expected to be "sufficiently similar" to justify similar regulatory treatment for all of them, just as out-of-region point-to-point markets could be "sufficiently similar" to one another -- though not to in-region markets -- to justify comparable regulatory treatment at this time.

We note again, however, that marketplace changes may require more refined market definitions in the future. Local competition can be expected to emerge more quickly for some services and in some geographic areas than in others. As a result, markets that have previously been "sufficiently similar" to one another may be quite different from one another in the future, and those differences may necessitate distinct regulatory approaches.

2. Exercise of Market Power

The NPRM discusses the potential risks from the exercise of upstream market power, either through cost misallocation or through actions that would "raise the costs" of the BOCs' downstream competitors. The Department agrees with many aspects of that discussion, but the conception of the competitive risks reflected in the NPRM is, in important respects, too narrow.

The NPRM observes that "improper allocation of costs by a BOC is of concern because such action may allow a BOC to recover costs incurred by its affiliate to provide interstate domestic interexchange services from subscribers to the BOC's local exchange and exchange access services. . . . For purposes of market power analysis, however, we are concerned with improper allocation of costs only to the extent it enables a BOC affiliate to set retail interLATA prices at predatory levels (i.e., below the costs incurred to provide those services), drive out its interLATA competitors, and then raise and sustain retail interLATA prices significantly above competitive levels." NPRM ¶ 135. In limiting its concerns to the possibility of predatory pricing, the Commission's approach is seriously flawed. So limited, the Commission would ignore the most likely anticompetitive effects of cost misallocation.

In addition to the predatory pricing strategy described in the NPRM, cost misallocation may cause substantial harm to consumers, competition and production efficiency. With respect to consumers, cost misallocation can adversely affect prices for essential monopoly services. Cost misallocation allows a provider of monopoly upstream services (i.e., local exchange and access services) to charge higher prices to the consumers of those services than it would charge absent the misallocation. Those prices are also higher than regulators would permit that provider to charge if the regulators could effectively prevent such misallocation.

With respect to competition and production efficiency, even if cost misallocation does not result in below-cost pricing that drives downstream competitors (i.e., interexchange carriers) out of the market, it still does have adverse effects. Misallocation shifts market share and profits away from those downstream competitors and to the upstream monopolist engaged in the misallocation. It does so even if the monopolist is less efficient than the competitors. Two types of economic harm follow. More of the relevant service is produced by the less efficient monopolist, and less is produced by the more efficient downstream competitors, producing immediate inefficiencies and wasted resources. And by artificially and inefficiently depressing competitors' profitability, the misallocation can be expected to reduce future investment by those competitors to improve or expand their networks, and to develop innovative technologies and services.

When it takes these broader harms into account, the Commission will recognize that it should then turn to a broader ensuing question. It asks in the NPRM whether the structural safeguards in section 272, price cap regulation of the BOCs' access services, and proposed accounting safeguards are sufficient to prevent cost misallocation that would result in successful predatory pricing. NPRM, ¶ 138. But the Commission must also ask the more important question of whether regulation would prevent cost misallocation that would have the other adverse consumer and economic effects identified above. From this broader perspective, the inadequacies of regulation as a means to prevent misallocation become more apparent. The Commission can and should attempt to reduce anticompetitive cost misallocations through carefully devised rules, but it should be under no illusions that regulatory measures alone will prevent competitively significant cost misallocations, so long as incentives remain to engage in such practices. Those incentives can be eliminated only when the local exchange market is subject to robust competition.

The NPRM also discusses risks that BOCs might use their market power in local exchange and access services to raise their long distance rivals' costs or restrict their output. These risks are substantial, and they cannot effectively be dealt with through regulatory measures alone. It is also important to recognize clearly the nature of these risks. In particular, anticompetitive consequences will result if an upstream monopolist causes its downstream rivals' costs to exceed the costs that would prevail absent upstream market power. In a vertically integrated firm, the downstream affiliate's economic cost of an input is equivalent to the "competitive" price of that input; if rivals must pay more than a competitive price when they purchase inputs from the monopolist, they will be artificially disadvantaged. This is true regardless of whether costs are "raised" from current levels, or from levels that might otherwise be anticipated in the future.

3. Regulation to Address This Market Power

In Section VI above, concerning enforcement of Section 272, we suggest several regulatory measures which are likely to reduce the risks that upstream market power would be exercised through some forms of anticompetitive cost misallocation and discrimination. Both BOCs and their affiliates should be required to file periodic, detailed reports concerning all costs arising from sources not independent of the other. Similar reports should concern the quantity, quality and timing of services provided by the BOC to its affiliate, and by the affiliate to its parent. Affiliates should be required to maintain current, auditable books according to generally accepted accounting principles. The burden of proof in 90-day complaint proceedings should be shifted to the BOC or its affiliate, and no presumption of reasonableness should attach in complaints concerning violation of Section 271.

tailored to address the competitive risks involved in this context. Those rules were designed primarily to curb abuses of market power through the reduction of output by a dominant carrier. But when the rules are applied to an affiliate in a downstream market, they are at best a clumsy tool for controlling vertical leveraging of market power by the parent, if the parent can be directly regulated instead. Indeed, applying those rules to affiliates might, under some circumstances, adversely impact competition in the long distance market. For example in the domestic context, use of the §214 approval process as a way to constrain leveraging would likely have to be heavy handed that it could have undesirable consequences for competition as well. And requiring BOC affiliates to file tariffs with substantial notice periods under Section 203 could hinder the affiliates' pricing flexibility and facilitate implicit price coordination among long distance carriers.

The Commission in its NPRM and some commenters have suggested two respects in which the dominant rules might have some impact on the exercise of vertically leveraged market power. Cost data filed by the affiliates with their FCC tariffs may assist in the detection of cost misallocation. Price cap regulation of the affiliates may deter BOCs from disadvantaging long distance competitors by reducing any supranormal profit the BOC's affiliate might earn as a result. Both suggestions have some merit, but on balance we believe that any benefits to be gained from these measures are outweighed by their disadvantages.

The Commission must of course be able to track the assigned costs of transactions between an affiliate and its parent if cost misallocation is to be detected. Existing dominant carrier rules are, however, at once too narrow and broader than necessary to achieve this objective. Section 61.38 of the Commission's rules requires dominant carriers to file cost studies when they file tariff changes. But as a mechanism for detecting cost misallocation, Section 61.38 has several significant failings. Cost studies are filed only when tariffs are changed, and do not reflect costs incurred over regular time intervals. They do not contain any data about the costs of services provided to the parent by the affiliate. And Section 61.38 does not appear to require carriers to identify the sources of costs by individual vendors. Thus, an affiliate's complete cost study might leave all parties substantially in the dark as to which costs are attributable to its LEC parent.

On the other hand, Section 61.38 would also require affiliates to reports costs incurred from sources independent of their parents. Those costs would be of little or no relevance to any cost misallocation question. Requiring affiliates to identify those costs with tariff filings could unfairly handicap them in relation to their long distance competitors. Both these disadvantages and the shortcomings of Section 61.38 would be resolved in the system of periodic cost reports we suggest above.

Price cap regulation for long distance affiliates presents a more complex question. Such regulation does very likely constrain pricing in local exchange by BOCs. In that market, BOCs provide an essential service and they face relatively little competition. If price cap regulation of long distance affiliates had a similar constraining effect, it could reduce the incentive for BOCs to impose costs on long distance competitors. The affiliates might not be able to retain all of the financial benefit they might otherwise derive. But the impact of price cap regulation on affiliate pricing, and therefore its deterrence effect, is not so clear. The extent to which such regulation would initially constrain the affiliate's pricing and profits cannot be determined at this time, and after price caps are initially established, the affiliates likely would be permitted substantial pricing flexibility. As the Commission recognizes, moreover, "price regulation would not prevent the affiliate from profiting from the BOC's raising of rivals' costs through increased market share." NPRM, ¶ 132.

On the other hand, price cap regulation of affiliate rates could entail significant disadvantages. It will interfere with market determined pricing by the affiliates, resulting in less efficient investment and service decisions. It will be costly to the Commission and to litigants before the Commission, as it encourages extensive rent seeking by those litigants. And it may facilitate implicit price coordination among long distance carriers. On balance, we believe, these disadvantages outweigh any marginal benefit to be gained from price cap regulation of the affiliates.

By relying on measures tailored to address the problems at hand, the Commission would be following an approach similar to the one it took in its Foreign Carrier Entry Order. Market Entry and Regulation of Foreign-affiliated Entities, 11 FCC Rcd 3873 (1995). There, the Commission considered the means it should use to regulate international carriers which themselves operated in relatively competitive markets, but which were affiliated with foreign monopoly carriers. The Commission recognized that these carriers' market power resulted not from their own positions, but from their parents' "control of bottleneck services or facilities on the foreign end," control which could be "leveraged on international routes to the detriment of unaffiliated U.S. carriers." Id. at 3917, 3912. Although the Commission declared that U.S. international carriers with monopoly affiliates would be dominant, it exempted them from several of its dominant carrier rules. They were not, for example, required to file cost support data with their tariffs. The benefits of this requirement, the Commission held, are "outweighed by the burden imposed." "Moreover," the Commission continued, "competition in the market for international services is a better constraint on unreasonable prices than Commission review of a foreign carrier's cost support showing." Id. at 3973. For that reason, the Commission considered it appropriate to bar foreign entry altogether where foreign markets had not been sufficiently opened to competition.

The approach the Commission should take here differs slightly from its approach in the Foreign Carrier Entry Order because some factors which underlay that decision are not present here. There, the parents' bottleneck services and facilities were not themselves subject to U.S. regulation, and the Commission's ability to regulate terms of market entry by the foreign carriers, which the Commission gained through application of its dominant carrier rules, was a central concern. Neither factor obtains here. So the Commission need not and should not start from the same baseline, applying the dominant carrier rules unless otherwise stated. But the reasons why the Commission adopted a selective approach fully apply here. Market power derived solely from vertical leverage is not the type of market power for which the dominant carrier rules were designed.

Respectfully submitted,

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